DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0358
Indiana Corporate Income Tax
For the Years 1998 through 2001

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ISSUE

I. **Unrelated Business Income** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2.8; IC 6-3-2-3.1; 45 IAC 1.1-3-9; 45 IAC 1.1-3-9(a); 45 IAC 3.1-1-68; I.R.C. § 511; I.R.C. § 511(a); I.R.C. § 512; I.R.C. § 512(a); I.R.C. § 513; Deer Park Country Club v. Commissioner, 70 T.C.M. (CCH) 1445 (1995); 2002 U.S. Master Tax Guide (CCH 2002).

Taxpayer argues that it is not subject to adjusted gross income tax on the money it received from the sale of its real property and equipment.

STATEMENT OF FACTS

Taxpayer is a not-for-profit organization located within the state and qualified as an I.R.C. § 501(c)(7) organization. The taxpayer's main purpose was to own, operate, and maintain a facility for the members of an associated fraternal organization which, itself, was not in a position to own the property. In 1999, taxpayer sold the building, contents, and equipment.

During 2003, the Department of Revenue (Department) conducted an audit review of taxpayer's business records and tax returns. The audit resulted in an assessment of additional adjusted gross income tax. Taxpayer challenged this assessment, submitted a protest to that effect, an administrative hearing was conducted during which taxpayer further explained the basis for its protest, and this Letter of Findings results.

DISCUSSION

I. **Unrelated Business Income** – Adjusted Gross Income Tax.

The audit found that taxpayer owed adjusted gross income tax on the amount of money it received when it disposed of real and personal property in 1999. The audit did so under authority of IC 6-3-2-2.8 which states in part that "Notwithstanding any provision of IC 6-3-1 through IC 6-3-7, there shall be no tax on the adjusted gross income of the following: (1) Any organization described in Section 501(a) of the Internal Revenue Code, except that any income of such

organization which is subject to income tax under the Internal Revenue Code shall be subject to the tax under IC 6-3-1 through IC 6-3-7."

The audit concluded that the income *was* subject to income tax under the Internal Revenue Code based upon the I.R.C. § 512 definition of "unrelated business taxable income." I.R.C. § 512 states that, "Except as otherwise provided in this subsection, the term 'unrelated business taxable income' means the gross income derived by any organization from an unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with carrying on of such trade or business . . . ."

I.R.C. § 513 states that, "the term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . ."

I.R.C. § 511 imposes a federal income tax "on unrelated business income of charities" including "organizations described in sections 401(a) and 501(c)." I.R.C. § 511(a). I.R.C. § 512 states that unrelated business income consists of the gross income from any unrelated trade or business "regularly" carried on minus business deductions directly connected with the unrelated business income. I.R.C. § 512(a). To be taxable, income must be from a business not substantially related to the exercise of the charitable, educational, or other purpose on which the exemption is based. I.R.C. § 513.

Taxpayer argues that the income is not subject to the state adjusted gross income tax because only the unrelated business income as defined in I.R.C. § 513 is subject to adjusted gross income and supplemental net income tax. Taxpayer cites as authority IC 6-3-2-3.1 which states in part that, "Except as otherwise provided in subsection (b), income is not exempt from the adjusted gross income tax, or the supplemental net income tax, under section 2.8(1) of this chapter if the income is derived by the exempt organization from an unrelated trade or business as defined in Section 513 of the Internal Revenue Code." IC 6-3-2-3.1(a). *See also* 45 IAC 3.1-1-68. According to taxpayer, because the income comes within the definition found under § 512(a)(3), it is not subject to state tax under IC 6-3-2-3.1.

"Although, under Code Sec. 501, a variety of nonprofit philanthropic or mutually beneficial organizations may be granted tax-exempt status, they may become subject to tax on income from a business enterprise not related to their purpose." 2002 U.S. Master Tax Guide para. 655, p. 211 (CCH 2002). I.R.C. § 512(a) provides in relevant part as follows:

> For purposes of this title (3) Special rules applicable to organizations described in section 501(c)(7) or (9) . . . (D) Nonrecognition of gain . . . If property used directly in the performance of the exempt function of an organization described in section 501(c)(7) or (9) is sold by such organization, and within a period beginning 1 year before the date of such sale, and ending 3 years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property. For

> purposes of this subparagraph rules similar to the rules provided by subsections (b), (c), (e), and (j) of section 1034 shall apply.

The audit report found that "The taxpayer did not purchase other property within the 3 year time limit; therefore, they must recognize the full gain on the property sold as 'unrelated business taxable income.'" In addition, the audit report found that "the taxpayer did not set aside interest and dividends income derived from the investment of receipts from the sale of the property over the 3 year period as required under IRC 512(a)(3)(B) for determining 'exempt function income' . . . [therefore] it too becomes 'unrelated business taxable income' as defined under IRC § 512." The secondary reference to which the audit report refers is found at I.R.C. § 512(a)(3)(B) which defines "exempt function income" as "all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (2)), which is set aside (i) for a purpose specified in section 170(c)(4), or (ii) in the case of an organization described in paragraph (9), (17), or (3) of section 501(c) to provide for the payment of life, sick, accident or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii)."

In other words, the audit report found that taxpayer did not reinvest the money it earned from the sale of its property within three years and did not use the interest earned on that same money for an exempt purpose. Taxpayer does not contest either of these conclusions.

Taxpayer is correct that that the term "unrelated trade or business" is defined in I.R.C. § 513. However, the term "unrelated business taxable income" is defined in I.R.C. § 512. The two sections must be read together to determine what is "unrelated trade or business" and whether income from that "unrelated trade or business" constitutes "unrelated business taxable income." I.R.C. § 511 imposes a tax on the "unrelated business income of charitable etc. organizations," I.R.C. § 513 sets out the definition of "unrelated trade or business," and I.R.C. § 512 explains how to determine the amount of "unrelated business taxable income." The income taxpayer derived was from an "unrelated trade or business" as defined under I.R.C. § 513 and becomes subject to the state's adjusted gross (and supplemental net income) tax pursuant to IC 6-3-2-3.1.

In Deer Park Country Club v. Commissioner, 70 T.C.M. (CCH) 1445 (1995), the court stated that, "The plain language of section 512(a)(3)(D) limits nonrecognition treatment to gains realized on the sale of property used directly in the performance of the organization's exempt function." The court concluded "that the plain and ordinary meaning of the phrase 'used directly in the performance of the exempt function of an organization' as set forth in section 512(a)(3)(D) connotes an exempt organization's use of assets or property that is both actual and direct in relation to the performance of its exempt function." The court concluded that the petitioner – an I.R.C. 501(c)(7) organization – was not entitled to nonrecognition treatment for the money it received when it sold a portion of its property to a housing development because the money was not used directly in the performance of the taxpayer's exempt function.

As an organization described in I.R.C. § 501(a), taxpayer was entitled to the state tax exemption provided under IC 6-3-2-2.8. However, that state exemption ended to the extent that taxpayer received income "subject to income tax under the Internal Revenue Code . . . ." IC 6-3-2-2.8.

Nonetheless, taxpayer points out that the audit found that the income was not subject to gross income tax pursuant to 45 IAC 1.1-3-9. Taxpayer's argument is that if the income was not subject to gross income tax, that same income cannot be subject to adjusted gross income tax. The cited regulation states in relevant part that, "Except as provided in subsections (b), (c), and (e) a taxpayer organized and operated for fraternal or social purposes or as a business league or association is not subject to the gross income . . . ." 45 IAC 1.1-3-9(a) However, the regulation also states that "The exemption provided by subsection (a) does not apply to gross income derived from an unrelated trade or business as defined in Section 513 of the Internal Revenue Code." Taxpayer is correct in pointing out that the audit's conclusion – that the income from the sale of the property *was not* subject to gross income tax pursuant to 45 IAC 1.1-3-9 but *was* subject to adjusted gross income tax – is inconsistent.

However, the answer to taxpayer's challenge is that the audit erred in concluding that the income was not subject to gross income tax. The regulation plainly stipulates that if the fraternal organization receives income from an "unrelated trade or business" as set out in I.R.C. § 513, that income is subject to the state's gross income tax. The money taxpayer received from selling real and personal property was unrelated to its fraternal purposes, falls within I.R.C. § 513, and loses the exemption set out in 45 IAC 1.1-3-9(a).

FINDING

Taxpayer's protest is respectfully denied.

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